

**DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 99-0438
STATE CORPORATE INCOME TAX
For 1993, 1994, 1995, and 1996**

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ISSUES

I. Adjusted Gross Income Tax– Business Income

Authority: 45 IAC 3.1-1-29; IC § 6-3-1-20; IC § 6-3-1-21; *Allied-Signal Inc. v. Director Div. of Taxation*, 112 S. Ct. 2251 (1992); *May Department Stores Co. v. Ind. Department of State Revenue*, 749 N.E.2d 651 (Ind. Tax 2001)

Taxpayer protests the proposed reclassification of nonbusiness income as business income.

II. Adjusted Gross Income Tax – Foreign Dividend Deduction

Authority: IC § 6-3-2-12

The taxpayer protested the auditor's adjustments adding back taxpayer's Federal foreign dividend expense deductions to taxpayer's foreign dividend income deduction when calculating Adjusted Gross Income.

III. Adjusted Gross Income Tax – Calculation

Authority: None Cited.

The taxpayer protested an audit calculation that impacted other computations within taxpayer's return and which was then reversed without subsequent corrections.

IV. Adjusted Gross Income- Adjustments

Authority: None cited.

Taxpayer requests adjustments to assessment based on letter of finding and court results.

V. Adjusted Gross Income- Net Operating Carryforward

Authority: None cited.

Taxpayer protests classification of net operating carryforward as non-business income.

VI. Income Tax - Penalty

Authority: 45 IAC 15-11-2; IC § 6-8.1-10

Taxpayer protests the negligence penalty assessment for under reporting and under payment of estimated tax.

STATEMENT OF FACTS

Taxpayer is an industrial chemical manufacturer with production facilities located outside of Indiana. Taxpayer's holdings included both foreign investments and a 23.8% direct ownership, with a combined 71% ownership in a pharmaceutical company. Taxpayer sold the pharmaceutical company interests after 6 years of ownership and reported its proceeds from this sale as nonbusiness income, which the audit reclassified as business income. Taxpayer also received foreign dividends, which it deducted both as business expenses and as foreign dividends, audit eliminated the alleged double deduction. Taxpayer is protesting these adjustments and requesting recalculations of the audit adjustments and waiver of the penalty related to these transactions.

I. Adjusted Gross Income Tax– Business Income

DISCUSSION

“Business income” and “nonbusiness income” are defined by the Indiana Code as follows:

Sec. 20. The term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations.

Sec. 21. The term "nonbusiness income" means all income other than business income. IC § 6-3-1-20 and 6-3-1-21.

The terms are similarly defined by the Indiana Administrative Code:

Sec. 29. “Business Income” Defined. “Business Income” is defined in the Act as income from transactions and activity in the regular course of the taxpayer's trade or business, including income from tangible and intangible property if the acquisition, management, or disposition of the property are integral parts of the taxpayer's regular trade or business.

Nonbusiness income means all income other than business income.

The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, non-operating income, etc., is of no aid in determining whether income is business or nonbusiness income. Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is “business income” or “nonbusiness income” is the identification of the transactions and activity which are the elements of a particular trade or business. 45 IAC 3.1-1-29.

In *May Department Stores Co. v. Ind. Department of State Revenue*, 749 N.E.2d 651 (Ind. Tax 2001), the Indiana Tax Court determined that IC § 6-3-1-20 provides for both a transactional test and a functional test in determining whether income is business or non-business in nature. *Id.* at 662-3.

The court looks to 45 IAC 3.1-1-29 and 30 for guidance in determining whether income is business or business income under the transactional test. These regulations state “...the critical element in determining whether income is ‘business income’ or ‘nonbusiness income’ is the identification of the transactions and activity which are the elements of a particular trade or business.” *Id.* at 664. 45 IAC 3.1-1-30 lists several factors in making this determination. These include the nature of the taxpayer’s trade or business; substantiality of the income derived from activities and relationship of income derived from activities to overall activities; frequency, number or continuity of the activities and transactions; length of time income producing property was owned; and taxpayer’s purpose in acquiring and holding the property producing income. In *May*, the Court found that the transactional test was not met when a retailer sold a retailing division to a competitor because the taxpayer was not in the business of selling entire divisions. *Id.* at 664.

Taxpayer notes that taxpayer corporation retained ownership of the target corporation for six years, thus not constituting an interim use of idle funds. Additionally; taxpayer notes that its interest in this corporation was part of a strategy to stabilize the corporation’s yearly earnings. Taxpayer corporation’s sales follow national economic fluctuations while the target corporation being a pharmaceutical business was far less responsive to market fluctuations and its purchase was part of what taxpayer identified as a ‘defensive’ market strategy.

Taxpayer notes that contrary to the audit findings, taxpayer directly owned 23.83% and indirectly –through subsidiary corporations- owned 71% of the corporation in question, not the 100% ownership alleged in the report.

Taxpayer’s sale of long held stock of the target corporation does not meet the transactional test.

The functional test focuses on the property being disposed of by the taxpayer. *Id.* at 664. Specifically the functional test requires examining the relationship of the property at issue with the business operations of the taxpayer. *Id.* at 664. In order to satisfy the functional test the property generating income must have been acquired, managed and disposed of by the taxpayer in a process integral to taxpayer’s regular trade or business operations. *Id.* at 664. The Court in

May defined “integral” as part or constituent component necessary or essential to complete the whole. *Id.* at 664-5. The Court held that the *May*’s sale of one of its retailing division was not “necessary or essential” to *May*’s regular trade or business because the sale was executed pursuant to a court order that benefited a competitor and not *May*. In essence, the Court determined that because *May* was forced to sale the division in order to reduce its competitive advantage, the sale could not be integral to *May*’s business operations. Therefore, the proceeds from the sale were not business income under the functional test.

Taxpayer acquired its interest in the target company as part of a merger of a wholly owned subsidiary of taxpayer and an unrelated company, both of which were pharmaceutical companies. The acquisition of taxpayer’s interest in the target company was intended to expand a line of business in which taxpayer was already engaged through its wholly owned subsidiary. Since the acquisition of taxpayer’s interest in the target company resulted in expansion of an existing business line, its acquisition was clearly integral to the taxpayer’s trade or business. Taxpayer, by its own admission, maintained its interest in the target company as part of a strategy to minimize risk through diversification. Therefore, taxpayer management of its interest in the target company was integral to its trade or business. Taxpayer has failed to submit any evidence that its disposition of its interest in the target company was not integral to its trade or business. Since taxpayer’s acquisition and management of its interest in the target company was integral to its trade or business, the Department will presume that its disposition was integral to its trade or business absent evidence to the contrary.

The Indiana Tax Court in *May Department Stores Co. v. Ind. Department of State Revenue*, 749 N.E.2d 651 (Ind. Tax 2001) requires both a transactional and functional analysis to determine the existence of business or nonbusiness income. Taxpayer has not demonstrated that the target company was not integral to its trade or business, thus the functional test has been met and the classification of this income as business income was correct.

FINDINGS

Taxpayer protest is denied.

II. Adjusted Gross Income Tax – Foreign Dividend Deduction

DISCUSSION

In calculating its Indiana tax liabilities, taxpayer, pursuant to IC 6-3-2-12, deducted foreign source dividend income from its Indiana adjusted gross income. Audit, however, disagreed with taxpayer’s calculus. Re-calculation by Audit resulted in an increase in taxpayer’s Indiana adjusted gross income and tax. Proposed assessments of Indiana adjusted gross income tax followed.

Taxpayer, in response, directs the Department’s attention to the language of IC 6-3-2-12(b), which states:

A corporation that includes any foreign source dividend in its adjusted gross income for a taxable year is entitled to a deduction from that adjusted gross income. The amount of the deduction equals the product of:

the amount of the foreign source dividend included in the corporation's adjusted gross income for the taxable year; multiplied by the percentage prescribed in subsection (c), (d), or (e), as the case may be.

The aforementioned subsections (c), (d), and (e) allow corporate taxpayers to receive a one hundred percent (100%) deduction for foreign source dividends received from corporations in which a taxpayer has an eighty percent (80%) or larger ownership interest; an eighty-five percent (85%) deduction for dividends received from corporations in which a taxpayer has a fifty to seventy-nine percent (50%-79%) percent ownership interest; and a fifty percent (50%) deduction for dividends received from corporations in which a taxpayer has less than a fifty percent (50%) ownership interest. IC 6-3-2-12(c)-(e).

This statutory language is cogent and clear. IC § 6-3-2-12 authorizes pro rata deductions (based on the percentage ownership of the payor by the payee) of certain foreign source dividend income. In this instance, taxpayer has followed the statutory prescriptions in calculating its foreign source dividend deductions.

FINDING

Taxpayer's protest is sustained.

III. Adjusted Gross Income- Calculation

DISCUSSION

At one time during the audit, the auditor inadvertently deducted from non-business income expenses associated with the qualifying dividends deduction. Taxpayer and Department agree that this is an error and the appropriate adjustment will be made.

FINDING

Taxpayer protest sustained.

IV. Adjusted Gross Income- Adjustments

Throughout the protest, taxpayer has requested that any changes in business or non-business classifications, losses, or income, be reflected in the Department's assessment against taxpayer. Additionally, taxpayer notes the taxpayer has some issues that are currently before the Tax court that could result in adjustments that might affect this assessment and taxpayer is requesting that no adjustments related to these issues be permitted until a settlement or judgment is entered. The Department respectfully notes that any adjustments required by this letter of findings will serve

to change the nature of all related calculations of this assessment and that any modifications due to court settlements or judgments that do not yet exist are rather speculative, but that generally any changes related to this audit period will be addressed at the time of the aforementioned settlement or judgment depending on the terms and requirements of the aforementioned settlement or judgment.

FINDING

Taxpayer protest denied.

V. Adjusted Gross Income- Net Operating Carryforward Classifications

Taxpayer argues that during the audit numerous capital loss carryforwards generated during tax years 1988-1994 were not included on taxpayer's filed returns and were discovered by taxpayer and claimed-by taxpayer- as subtraction modifications to the extent of capital gains. While the audit allowed part of this belated claim, it treated all of the capital loss carryforwards as nonbusiness income based on the determination that the capital losses incurred and capital loss carryforwards incurred were from income that was classified as non-business income. Taxpayer argues that taxpayer was entitled to claim some of the carryforward amounts as business losses and that audit's determination of the capital loss income as non-business was incorrect.

Taxpayer has made a general request that the Department should revisit taxpayer's books and review all transactions related to these losses and determine on taxpayer's behalf how taxpayer should-or could- have originally claimed these amounts on taxpayer's returns for the years in question. In taxpayer's argument the information provided by taxpayer does not support this claim. The Department respectfully declines taxpayer's invitation.

FINDING

Taxpayer protest denied.

VI. Adjusted Gross Income-Penalty

DISCUSSION

Penalty waiver is permitted if the taxpayer shows that the failure to pay the full amount of the tax was due to reasonable cause and not due to willful neglect. IC § 6-8.1-10. The Indiana Administrative Code further provides in 45 IAC 15-11-2:

(b) "Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow

instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

(c) The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty-giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

- (1) the nature of the tax involved;
- (2) judicial precedents set by Indiana courts;
- (3) judicial precedents established in jurisdictions outside Indiana;
- (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;
- (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

Taxpayer argues that the penalty was inappropriate based on taxpayer's exemplary prior performance and the reasonable nature of the calculations generating the taxable amount. Standing alone neither of the taxpayer's arguments is dispositive but they are factors which are indicative of the taxpayer's reasonable care, caution, or diligence.

FINDING

Taxpayer protest sustained.